

Internal Revenue Service
memorandum

CC:TL-N-8585-89

Br2:JMPanitch

date: **OCT 23 1989**

to: Los Angeles District Counsel
Attn: Philip J. Starr

CC:LA

from: Assistant Chief Counsel
(Tax Litigation)

CC:TL

subject: [REDACTED]

This memorandum responds to your July 21, 1989 request for Tax Litigation Advice in the above-referenced case. The case is in docketed status, and Judge [REDACTED] has set it for trial in Los Angeles on the [REDACTED] trial calendar.

ISSUE

Whether I.R.C. § 7701¹ treats the one man business trust to which petitioner transferred his engineering business as a trust or as an association for federal tax purposes.

CONCLUSION

Petitioner's sole beneficiary/trustee status does not preclude treating the trust as an association for federal income tax purposes. Further state law analysis is necessary before an informed determination may be made. Additionally, we recommend that attention be given to attacking the [REDACTED] as a sham trust.

DISCUSSION

FACTS:

In [REDACTED] and [REDACTED] petitioners [REDACTED] and [REDACTED] husband and wife, lived in California. [REDACTED] was an engineer by trade. On [REDACTED], [REDACTED] signed a trust instrument entitled "[REDACTED]" (the Trust). Trust Instrument (TI), pp. 1, 10.

¹ Unless otherwise stated, all section references are to the Internal Revenue Code as in effect during the years in issue.

It is not known what assets, if any, [REDACTED] transferred to the Trust. ² TI, p. 1.

The trust instrument acknowledged [REDACTED] as grantor and named [REDACTED] the sole trustee. TI, 1. The trust instrument vested the trustee with authority to "engage in any and all activities, businesses, and ventures, whether or not for profit as may be lawful under the applicable laws of the state of California. TI, 1. The trust instrument required the trustee to exercise this authority "in a fiduciary capacity primarily in the interest of the Beneficiaries" TI, 7. In addition, the trust instrument created [REDACTED] "shares" of beneficial interest, TI, 2. The trustee was given authority to either transfer or retain the shares for any consideration he deemed fitting or for no consideration at all. TI, 1. The trustee's retention of the shares was intended to have no effect on his status or power as a "Trustee". TI, 2. The shares purportedly entitled their holders, "the Beneficiaries of the Trust", to "participate in all dividends and other distributions of income or principal" at the trustee's sole discretion. TI, 2. The trust instrument contains no restrictions on the beneficiaries' rights to transfer shares. The trust instrument does not indicate whether or not [REDACTED] transferred any shares.

Pursuant to the trust instrument, neither "the death, insolvency, nor incompetency of a Beneficiary, nor the transfer of share certificates" would terminate or dissolve the Trust. TI, 2. The trust instrument gave the trustee absolute discretion to terminate the Trust at any time. TI, 9.

The trustee was authorized to pay "dividends" out of the net earnings of the Trust. TI, 3. Timing and amount was left to the trustee's sole discretion. TI, 3. The trust instrument gave the holders of beneficial interests no rights to trust property. TI, 3.

The trust instrument purported to limit the beneficiaries' liability to the amount of the Trust's assets. TI, 4. The trust instrument also purported to limit the trustee's liability to third-parties in either contract or tort to the Trust's assets and indemnified the trustee against loss. TI, 8.

The trustee was intended to receive any amount of compensation that he deemed "reasonable and proper." TI, 5. Pursuant to the trust instrument, "any act or thing done by the Trustee, or by the officers or agents of the Trust under authority from the Trustee, [would] as to strangers dealing with such Trustee,

² [REDACTED] claims to have transferred "few if any assets" to the Trust. Petitioner's Trial Memorandum, p. 2 [REDACTED]. This assertion should be investigated.

officers or agents, be conclusively deemed to be within the purpose of th[e] trust and within the powers of the Trustee or any of them" TI, 9. The provisions regarding amendment of the trust instrument are ambiguous, but appear to have required the consent of holders of at least [REDACTED] of the shares of beneficial interest. TI, 9. There is little, if any, evidence in the file regarding the extent to which [REDACTED] honored the Trust's provisions.

During [REDACTED] and [REDACTED], the Trust contracted out [REDACTED]'s services. Request for Tax Litigation Advice (RTLA), p. 1; Petitioners' trial memorandum, p. 1. The Trust paid [REDACTED] an unstated amount for his services. RTLA, p. 1. The Trust reported deductions for expenses and various pension and retirement payments. RTLA, 1. These deductions resulted in the Trust's reporting of a loss. RTLA, 1.

On [REDACTED], the Phoenix Appeals office sent petitioners a statutory notice for [REDACTED] and [REDACTED]. The Commissioner's deficiency determination resulted from a reallocation of compensation income from the Trust to [REDACTED] in his individual capacity pursuant to the grantor trust provisions. Petitioner has contended that the Trust should be treated as an association taxable as a corporation under section 7701(a)(2). You have requested our advice regarding the proper application of the entity classification rules -- especially the "associates" and "joint business objective" requirements -- to the Trust.

ANALYSIS:

Section 7701 provides rules for entity classification. Section 7701(a)(3) categorizes "associations" as corporations for federal tax purposes. Treas. Reg. § 301.7701-2 interprets the term "association". To determine whether an organization is an "association" and, thus, should be treated as a corporation, the regulations focus on six characteristics generally found in corporations. These characteristics are:

1. Associates;
2. An objective to engage in business and to divide the gains therefrom;
3. Continuity of life;
4. Centralization of management;
5. Liability for corporate debts limited to corporate property; and
6. Free transferability of interests.

Treas. Reg. § 301.7701-2(a)(1); Also See, Morrissey v. Commissioner, 296 U.S. 344, 359 (1935). An unincorporated organization will be classified as an association taxable as a corporation if it has characteristics one and two, above, and at least three out of four of characteristics three through six. See Treas. Reg. § 301.7701-3; Larson v. Commissioner, 66 T.C. 159, 185-86 (1976).

The entity at issue here was organized as a trust under California law. To determine whether or not the Trust will be treated as a trust for federal tax purposes, we will initially examine characteristics 1. and 2., above. If the Trust has associates and an objective to engage in business and divide the gains therefrom, then it will not be treated as a trust for federal tax purposes. Treas. Reg. § 301.7701-2(a)(2).

1. and 2. Associates and An Objective to Engage in Business and Divide the Gains Therefrom:

In Hynes v. Commissioner, 74 T.C. 1266, 1279-81 (1980), the Tax Court determined that a business trust, having a single beneficiary/trustee, would be considered as possessing associates and an objective to engage in business and divide the gains therefrom. Also See Lombard Trustees v. Commissioner, 136 F.2d 22, 23 (9th Cir. 1943). Moreover, in G.C.M. 36596, [REDACTED] (May 1, 1981), the Service adopted the Hynes approach. Accordingly, the existence of a single beneficiary/trustee will not preclude the Trust from being treated as an association for federal income tax purposes. The threshold inquiry, then, is whether [REDACTED] formed the Trust to engage in business for profit or, rather, merely to protect or conserve property.

The trust instrument authorizes the trustee to engage in any lawful business activity at the trustee's discretion. A trust has a business objective where the trust provides authority to engage in business activity, regardless of whether or not the trust, in fact, engages in any business activity. Helvering v. Coleman-Gilbert Associates, 296 U.S. 369, 373-74 (1935); Rev. Rul. 75-258, 1975-2 C.B. 503. Thus, no further inquiry is required in order to decide whether the Trust has a business objective. Nonetheless, we note both that the Trust apparently

³ Treas. Reg. § 301.7701-4 states general considerations for determining whether a trust more closely resembles a trust or a corporation for federal tax purposes and refers to Treas. Reg. §§ 301.7701-2 and -3 for a determination of the question in any particular case.

had few, if any, assets to be protected or conserved and that significant business activity apparently took place. Moreover, petitioners argue for "association" status; thus the proposition that the Trust had a business objective should be noncontroversial. Accordingly, we conclude that the Trust had associates and a joint business purpose and should not be treated as a trust for federal tax purposes.

This conclusion does not end the inquiry, however. The Trust must contain at least three out of four of characteristics three through six. before the Trust will be treated as an association and taxed as a corporation. G.C.M. 39395, [REDACTED] (June 24, 1983).

3. Continuity of Life:

The trust instrument gives the trustee absolute power and discretion to terminate the Trust at any time. Service position is that this power deprives the Trust of continuity of life. G.C.M. 39395 fully explains the rationale for this position.

4. Centralization of Management:

The trust instrument gives the trustee sole discretion to manage the trust operations. Under these circumstances, the Trust has centralization of management. See G.C.M. 39395. The taxpayer agrees with this conclusion. Since this conclusion is noncontroversial, no further discussion is necessary.

5. Limited Liability:

Although the trust instrument purports to limit the liability of the trustee and any beneficiaries to the trust's property, California law may hold otherwise. Further research in this regard is warranted. See G.C.M. 39395.

6. Free Transferability of Interests:

The trust instrument places no restrictions on transfer of the "shares". Accordingly, the Trust has the characteristic of free transferability of interests. Treas. Reg. § 301.7701-2(e).

Pursuant to the above analysis, the Trust has centralization of management and free transferability of interests but lacks continuity of life. Further analysis of state law is required to determine whether the Trust has limited liability. If the trustee/beneficiary does not have limited liability under

California law, the Trust would be treated as a sole proprietorship for federal tax purposes. G.C.M. 39395. If, however, the trustee/beneficiary has limited liability under state law, the Trust would be classified as an association taxable as a corporation under section 7701.


We believe, however, that section 7701 is not the weapon of choice in this case. The wide discretion invested in the trustee under the trust instrument gives the case the distinct odor of sham trust. Further attention should be given to the potential application of Markosian v. Commissioner, 73 T.C. 1236 (1980), Vercio v. Commissioner, 73 T.C. 1246 (1980), and their progeny. The sham trust argument offers the Court an opportunity to "follow its nose" without even reaching the section 7701 issue. E.g., Lundgren v. Commissioner, T.C. Memo. 1981-136; Donald F. Shuman Equity Trust v. Commissioner, T.C. Memo. 1981-264. In this light, it appears that the Trust was one piece of an overall scheme to evade federal tax through the use of sham trusts. Petitioners have already conceded adjustments attributable to their use of two family trusts to improperly reduce their tax burden in the same taxable years.

CONCLUSION

Petitioner's status as sole beneficiary/trustee does not preclude treating the Trust as an association for federal income tax purposes. Further state law analysis is necessary, however, before we may properly classify the Trust. If the trustee/beneficiary's liability was truly limited, then section 7701 would treat the Trust as an "association" for federal tax purposes. If not, then the Trust would be treated as a sole proprietorship. Finally, further consideration should be given to attacking the Trust as a sham trust.

MARLENE GROSS

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Attachment: G.C.M. 38707
G.C.M. 39395